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Insolvency law must protect homebuyers, avoid complex resolution process

A more effective solution would be to adopt the waterfall mechanism from the FSC framework, which prioritises the interests of customers over those of other claimants

M S Sahoo | Raghav Pandey |

Illustration: Ajay Mohanty

The Insolvency and Bankruptcy Code, 2016 (IBC), much like insolvency law in any jurisdiction, revolves around the debtor-creditor relationship. Simply put, a creditor is someone who has lent money, while a debtor is someone who has borrowed it. When the debtor fails to service its debt, the insolvency process is triggered. What sets the IBC apart is its classification of creditors into two broad types. The first is financial creditors (FCs), such as banks and financial institutions, that have lent money and, in most cases, charge interest on the amounts lent. The second is operational creditors (OCs), who have not lent money per se but are owed money for goods and services supplied on credit.

This classification serves an important purpose: It delineates distinct rights for the two types of creditors. Both have defined economic rights with claims on the debtor's assets, which will be discussed later. The key difference lies in their political rights: FCs get to sit on the Committee of Creditors (CoC), the primary decision-making body during the IBC process, while OCs do not. The rationale for including only FCs on the CoC is twofold. First, as primarily financial institutions, FCs possess the commercial expertise necessary to make informed decisions about the debtor's future. Second, they are in a better position to restructure the debts owed to them. However, the basis of this classification and the rationale for granting differing rights, though upheld by the Supreme Court, remains debatable, a topic for another day.

The IBC provides for the insolvency resolution of real sector companies (RSCs), but it excludes financial service providers (FSPs), which are structurally different from RSCs. While RSCs primarily rely on debt and equity funding, FSPs mainly operate using customers' funds or third-party assets — such as those in escrow accounts, investments in mutual funds, and margin money in trading accounts — alongside a regulatory minimum of debt and equity. Due to these differences, FSPs require an altogether different dispensation for insolvency resolution, which is currently under development. Given the significant stake of customers, the decision-making authority for resolving stress in an FSP typically lies with a public authority, in contrast to the creditor-driven process for RSCs.

A key principle guides the economic rights of stakeholders during insolvency. There exists an inverse relationship between the claim on the assets of the insolvent entity and the level of risks associated with that claim. This principle is reflected in the hierarchy of claims: Customers, who take little to no risk, are at the top of the priority list, while equity holders, who bear the highest risk, are placed at the bottom. Creditors fall in between; they assume more risk than customers but less than equity holders. Among creditors, secured creditors rank higher in the distribution due to their lower risk compared to unsecured creditors. In RSCs, which typically do not hold customers' money, customers do not explicitly figure in the waterfall or are grouped with OCs. Conversely, in the case of FSPs, customer claims are prioritised at the top, with additional protections from the state and insurance mechanisms to address any shortfalls.

Some entities are hybrids of RSCs and FSPs. They conduct business using a combination of debt, equity, and customer funds. A notable example in India is real estate companies (RECs) that have adopted financial and contractual innovations to fund their projects. These companies often sell under-construction homes, allowing them to collect sale proceeds in instalments, which are then used to finance ongoing construction. This arrangement benefits both parties: It reduces the company's reliance on bank financing and allows homebuyers (HBs) to stagger payments over time instead of paying a lump-sum upfront.

This model worked well as long as real estate companies delivered homes within the promised timeframes. However, challenges emerged when Jaypee Infratech Ltd (JIL), with thousands of HBs still awaiting their promised homes, was admitted to insolvency in August 2017. The IBC probably did not foresee the insolvency resolution of such companies. While it was widely acknowledged that HBs had a legitimate claim on the company's assets, there was ambiguity over their classification, whether they should be regarded as creditors and, if so, whether as FCs or OCs. If not classified as creditors, they would have no rights in the IBC process, leaving their interests unprotected.

HBs, who had invested their life savings into their dream homes and had been waiting for years, found themselves in a dire situation. With their claims exceeding those of the FCs in the JIL case, they demanded to be classified as FCs, as this would give them a voice in the resolution process and, crucially, over their future, including the possibility of finally securing a roof over their heads. Their plight drew widespread sympathy, including from both the legislature and judiciary. In response, the IBC was swiftly amended to classify HBs as FCs, ensuring they could participate in the decision-making process.

While this amendment offered some respite, it also introduced new complexities by vitiating the basis of the classification of creditors. Most HBs lack the commercial expertise required to decide the fate of the insolvent entity. Moreover, they may not have the capacity or willingness to accept the same level of haircuts on their investments as other FCs. In any case, the law has its limits, especially in situations where the insolvency process fails to deliver homes or the company proceeds to liquidation, leaving HBs without the resolution they hoped for.

To resolve the impasse, some have suggested creating a tailored insolvency regime for RSCs that addresses sector-specific challenges. However, this approach risks fragmenting a market-wide insolvency framework into a sector-specific one. Given the unique characteristics of each sector, this could lead to the proliferation of specialised insolvency frameworks. Such fragmentation would undermine the core objective of insolvency law, which is to ensure the efficient and optimal allocation of resources across the broader economy.

A more effective solution would be to adopt the waterfall mechanism from the FSC framework, which prioritises the interests of customers over those of other claimants who assume greater risks in supplying funds. This approach would ensure that customers, including HBs, have their economic rights statutorily protected, rather than being involved in the commercial intricacies of insolvency resolution. By safeguarding customers' interests across various sectors, this mechanism would not only preserve the efficient allocation of resources within the economy but also uphold the integrity of a unified insolvency framework.

The authors are, respectively, legal practitioner, and assistant professor at the National Law University, Delhi

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